Quantitative Economics and Statistics

Federal Tax Reform Update

Presented at the Federation of Tax Administrators Revenue Estimating and Tax Research Conference, October 10, 2005

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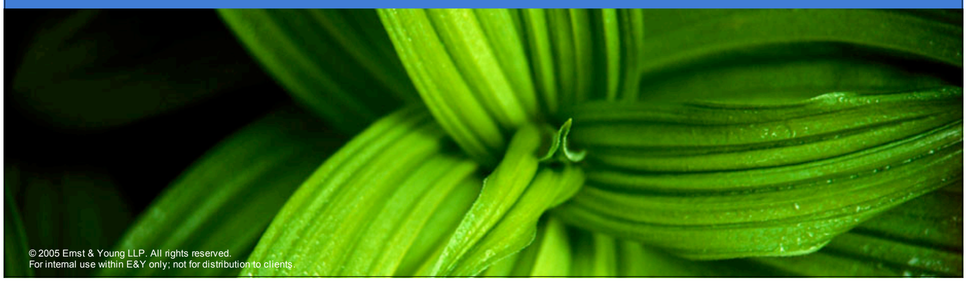

"Drivers" For Tax, Entitlement, Social Security Reforms?

- Rise in taxpayers subject to AMT
  - In 2003, 2 million tax returns had AMT liability of $11 billion.
  - in 2010, 20% of all taxpayers, and more than 90% of taxpayers with AGI between $100,000 and $500,000, will have AMT liability totaling total $90 billion.
  - Repeal of the AMT would cost $1.2 trillion over 10 years
- Many 2001/2003 Individual Tax Cuts Face Expiration
  - Lower rates on dividend and capital gains income expire in 2008
  - Individual rate cuts expire in 2010
- Aging of American workforce
  - 2008 is the first year of retirement for the "Baby Boomers"
  - Need for increased private savings

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Tax Reform Advisory Panel

- "Bipartisan Advisory Panel on Tax Reform" appointed by President in January 2005
  - Former Sen. Connie Mack (R-FL) (Chairman)
  - Former Sen. John Breaux (D-LA) (Vice-Chairman)
  - Other Panel members:

    Bill Frenzel *Timothy Muris*
    Elizabeth Garrett *Charles Rossotti*
    James Poterba *Liz Ann Sonders*
    Edward Lazear

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Fundamental Tax Reform - PROCESS

- Panel will submit "options" for reform to the Treasury Secretary by September 30, 2005 – Delayed to November 1
- Treasury expected to make recommendations to the President – Timing now uncertain – May not be public recommendations
- President Bush expected to submit his tax reform legislative recommendations to the Congress in 2006 – Not necessarily in the January budget

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Panel Mandate

- Advisory Panel's mandate:
  - **Simplification:** Simplify tax laws to reduce costs and administrative burdens of compliance
  - **Fairness:** Balance the burdens and benefits of the tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society
  - **Economic Growth:** Promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace

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Panel Restrictions

- Options will be revenue neutral
  - *Panel will use the revenue assumptions in the Bush FY06 budget as its "baseline" – these assume expiring rate reductions from the 2001 and 2003 tax changes don't take effect*
  - *Thus tax reform will be a tax cut from "current law"*
- At least one option should use the current Federal income tax as the base for its recommended reforms
  - Income tax reforms likely to move to consumption tax treatment
- Retain an incentive for home ownership and charitable giving
  - Retain "an" incentive, not "the current" incentive

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Panel Discussions

- Panel has held 10 public meetings to date
- Key topics:
  - Complexity burdens on individuals and businesses
  - Effect of the tax code on savings and investment
  - Pros/cons of income v. consumption taxes
    - International competition
    - Overall economic effects
    - Transition issues
    - Effect of reform on states
  - Cost recovery/tax incentives

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1986 "Revenue Neutral" Tax Reform

JCT Final Estimate, but Similar to Treasury's 1984 Proposal and President's 1985 Proposal

JCT Distribution Table

Income in class	% Change Income Tax
<$10k	-65.1%
10-20	-22.3
20-30	-9.8
30-40	-7.7
40-50	-9.1
50-75	-1.8
75-100	-1.2
100-200	-2.2
$200+	-2.4
Total	-6.6%

JCT Revenue Estimates
(1987-1991)

	$billions
Individual	-121.9
Corporate	120.3
Excise	1.5
Total	-0.3

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Fundamental Tax Reform Approaches

- **Revise current Code: incremental income tax reform**
  - "'86 Act" approach – broaden base to make permanent current tax rates and repeal AMT
  - Simplify savings incentives, depreciation, debt/equity
  - Exempt more retirement savings, further reduce double taxation of corporate income
- **Flat tax**
  - total employee compensation taxed at individual level
  - all businesses taxed under a cash flow tax (expensing with no interest deduction)
- **National retail sales tax**
- **European-style value-added tax**
- **"Hybrid" consumption/income tax**

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Potential Tax Rates for Different Bases

- Broad based income tax
  - 15% flat rate
  - Cut existing rates by over one third: 6.6-23%
- Comprehensive flat tax 21%
- National retail sales tax
  - Comprehensive, no rebates: 22-27% (tax exclusive)
  - Typical state base: 64-87% (tax exclusive)
- Value added tax 18%
  - Replace individual and corp. AMT 1%
  - Replace corp. income tax 3%
  - Replace AMT & cut regular rate 50% 10%

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Largest Individual Tax Expenditures

Top 12 Individual Tax Expenditures ($billions)	FY 2006-10
• Exclusion of employer contributions for medical insurance/care	760.2
• Deductibility of mortgage interest on owner-occupied homes	445.5
• Exclusion of pension contributions & earnings: 401(k)/IRA/Keogh	374.9
• Capital gains exclusion on home sales	247.2
• Net exclusion of pension contributions/earnings: Employer plans	241.0
• Deductibility of non-business state and local taxes	231.4
• Deductibility of charitable contributions	227.8
• Exclusion of net imputed rental income on owner-occupied homes	185.2
• Step-up basis of capital gains at death	164.4
• Child credit	164.0
• Non-business capital gains	144.2
• Exemption of interest on State and Local bonds	134.9
• Exclusion of interest on life insurance savings	129.5

Source: OMB, U.S. FY2006 Budget

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Largest Corporate Tax Expenditures

Top 10 Corporate Tax Expenditures ($billions)	FY 2006-10
• Deduction for U.S. production activities	42.9
• Deferral of income from controlled foreign corporations	42.7
• Exclusion of interest on State and local bonds	42.7
• Expensing of research and experimentation expenditures	30.7
• Graduated corporate income tax rate	19.6
• Credit for low-income housing investments	17.6
• Exclusion on interest on life insurance savings	14.1
• Special ESOP rules	11.1
• Inventory property sales source rules exception	11.0
• Exemption of credit union income	7.6
• Extraterritorial income exclusion	6.4

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Potential Consumption Tax Proposals

- All of the proposals are likely to include some movement toward consumption tax treatment
- Exempting investment income and expensing can be done as part of an "income" tax
  - The price is some limitation on interest deductions.
- A low rate value added tax to replace all/part of the individual income tax, corporate tax and/or payroll tax could be proposed
- A Comprehensive Business Income Tax or Flat Tax (X-Tax) would move toward consumption taxation

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Potential Individual Income Tax Reform

- Goal of simplicity, fairness (retaining current tax distribution) & growth (savings incentives)
  - Repeal of Individual AMT
  - Make expiring rate reductions permanent
  - Repeal some deductions (e.g., S&L taxes) & credits
  - Convert mortgage interest deduction to a credit at a 15% rate
  - Switch up-front saving incentives to no tax on investment income
  - Collect some tax on fringe benefits at business level

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Potential Business Tax Reform

- Resurrection of 1992 Treasury corporate integration proposal to eliminate corporate/non-corporate, debt/equity distinctions
- CBIT – Comprehensive Business Income Tax
  - Taxes all businesses, including non-corp., at entity level
  - Provides expensing of capital investment
  - Disallows interest deduction
  - Exempts business interest, dividends and other distributions of earnings at recipient level
  - No pass-through of "preference" items

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Other Business Tax Reform Options

- International tax reform
  - Territorial proposal – devils' in the detail
- Repeal corporate tax "preferences"
- Book tax conformity
- Collect income and payroll tax on certain employee fringe benefits at the business level
- Difficult to lower corporate tax rate below top individual marginal tax rate for both planning and tax accounting reasons

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Issues for State Revenue Estimators

- Treasury will present both traditional and "dynamic" revenue estimates of reform
  - Several models estimate moving to a pure consumption tax would increase national income by 2-6%
- Treasury estimates will assume no sunset of lower tax rates: less base expansion will be needed for revenue neutrality
- It will be difficult to lower regular marginal tax rates so incentives (e.g., expensing, savings incentives) will be done through base expansions and contractions
- Non-corporate businesses likely to be brought into the tax base, but with offset at individual level

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Summary

- It is very likely that the 1986 Tax Reform Act's shift of taxes away from individuals will be repeated
- The tax shift likely will be to all businesses, not just corporations
- The top individual tax rate and corporate tax rate are not likely to be lowered – incentives will take the form of deductions and credits
- Major changes to the Federal tax bases are likely to be proposed, which will make estimating State income tax changes difficult

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